IN THE

Supreme Court of the United States

No. .....

AMERICAN AUTOMOBILE ASSOCIATION, *Petitioner*,

v.

THE UNITED STATES OF AMERICA, *Respondent*

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

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PETITION

The American Automobile Association, by Fleming Bomar, its attorney, prays that a writ of certiorari be issued to review the judgment of the United States Court of Claims entered March 2, 1960, dismissing the petition of the American Automobile Association.

REPORT OF THE OPINION DELIVERED BY THE COURT BELOW

The opinion of the United States Court of Claims in this proceeding is reported at — Ct. Cls —; 181 F. Supp. 255. The opinion and findings of fact of the court below are appended hereto in accordance with Rule 23(a) of the rules of this Court.

STATEMENT OF GROUNDS ON WHICH JURISDICTION OF THIS COURT IS INVOKED

The United States Court of Claims entered its judgment in the proceeding below on March 2, 1960. On March 25, 1960, petitioner filed a timely motion for rehearing. On May 4, 1960, petitioner's motion for rehearing was overruled by an order entered by the United States Court of Claims on that date. Jurisdiction of this Court to review the judgment below rests upon 28 U.S.C. Sec. 1254.

QUESTIONS PRESENTED FOR REVIEW

1. Did this Court, in *Automobile Club of Michigan* v. *Commissioner*, 353 U.S. 180 (1957), decide that a method of accounting under which prepaid membership dues are reflected as income for tax purposes over the period of membership is, as a matter of law, "artificial" and unacceptable; or did this Court merely hold that the taxpayer there had failed, when challenged by the Commissioner of Internal Revenue, to establish, in his particular case, that the method as used by him was not "artificial?"

2. If a taxpayer proves by uncontradicted evidence, including expert accounting testimony, that its regularly employed method of accounting for prepaid membership dues is "realistic," is in accord with sound accounting principles, and reflects the taxpayer's income clearly, is that taxpayer to be denied the use of such method of accounting for federal income tax purposes by reason of the decision of this Court in *Automobile Club of Michigan, supra*?

STATUTE AND REGULATIONS INVOLVED

The applicable statutes and regulations involved are cited in the Appendix hereto. They are:

Internal Revenue Code of 1939	sections 41, 42(a)
Internal Revenue Code of 1954	sections 446, 451
Treasury Regulations	Regs. 118, sec. 39.41-1, 2 and sec. 39.42-1; Regs. 1.446-1; 1.451-1

A CONCISE STATEMENT OF THE CASE CONTAINING FACTS MATERIAL TO THE QUESTIONS PRESENTED

This is a federal income tax case. Petitioner, the American Automobile Association, seeks to recover from the United States the sum of $207,994.56 with interest according to law representing deficiencies in federal income tax and interest improperly collected by the United States for the calendar years 1952 and 1953.

Petitioner is a corporation with principal offices located at 1712 G Street, N. W., Washington, D. C. Petitioner was incorporated in the year 1910 under the laws of the State of Connecticut and was organized and is operated as a nonstock membership corporation. [R. 72].*

Petitioner's activities are divided into two major parts:

(1) Petitioner is a national organization which renders services to affiliated local automobile clubs and their members and which performs services of a public nature in fields relating to motor and travel. This aspect of petitioner's activities is not involved in this proceeding.

* The references marked "R" are to the consecutively paginated certified transcript of record.

(2) Petitioner operates directly, as divisions, ten local automobile clubs located in various sections of the United States.

A substantial part of the annual gross income of petitioner is derived from dues prepaid for one year in advance received from members of the ten local automobile clubs operated as divisions of petitioner. Petitioner is obligated to provide services for such members over the 12-month period following payment of dues, which services include but are not limited to a complete travel service, emergency road service, bail bond protection, personal automobile accident insurance and similar services. [R. 73].

Petitioner employs the accrual method of accounting in keeping its books and records and in filing its federal income tax returns. Its taxable year is the calendar year. [R. 74].

Under the method of accounting employed by petitioner during the years in issue advance dues collected from members of its divisions were not regarded as income for accounting purposes entirely in the calendar year of receipt but instead were recognized and reflected as income ratably over the 12-month period during which petitioner was obligated to render or make available services to such members—whether or not such period extended beyond the close of petitioner's taxable year. In other words, if a member joined the club on July 1, 1953 and prepaid dues for 12 months in the amount of $15.00, petitioner would reflect $7.50 as income in 1953 and the remaining $7.50 as income in 1954. [R. 76].

The method of accounting employed by petitioner during the years in issue had been used regularly by

petitioner since 1931 and was used both before and after petitioner was required to pay federal income taxes. The method of accounting employed by petitioner during the years in issue is in accord with generally accepted accounting principles and practices, is customarily and generally employed in the motor club field, and reflects its income clearly. [R. 20, 80].

Had the petitioner recognized, assigned and transferred to its gross income account its monthly receipts of dues collected in advance in the proportion to its cost of servicing all of its members each month, instead of ratably over the membership period of 12 months, the proportion of advance dues which would have been recognized and assigned to gross income during the years in issue herein would have been substantially the same as the gross income from dues as determined and reported by the plaintiff under the method of accounting actually employed. [R. 24, 82].

Petitioner's income tax return for the calendar year 1952 reflected net income of $152,975.51. Petitioner's income tax return for the calendar year 1953 reflected net income of $352,125.84. The 1954 tax return reported a net operating loss in the amount of $290,186.04. [R. 74].

Upon audit of petitioner's federal income tax returns for the calendar years 1952, 1953 and 1954, the Commissioner of Internal Revenue determined not to recognize the method of accounting employed by petitioner during the calendar years 1953 and 1954, which is the issue in this proceeding. The net effect of such determination was to increase petitioner's 1953 net income to $481,557.59 and reduce petitioner's 1954 net operating loss to $14,412.49. [R. 75].

As a result of the adjustments described above, the Commissioner of Internal Revenue asserted deficiencies in income tax for the calendar years 1952 and 1953, which were paid by petitioner in May, 1956. Petitioner filed timely claims for refund within two years and commenced suit July 8, 1958. [R. 76].

JURISDICTION OF THE COURT BELOW

The jurisdiction of the United States Court of Claims in the proceeding below rested upon 28 U.S.C. Sec. 1491.

REASONS RELIED ON FOR ALLOWANCE OF THE WRIT

There are two basic reasons why a writ should be allowed in this case.

1. The decision of the Court of Claims is in direct conflict with the recent decision of the Court of Appeals for the Second Circuit in *Bressner Radio, Inc.* v. *Commissioner*, 267 F. (2d) 520 (1959), involving the identical issue; and

2. An important question of federal income tax law is involved which has not been, but should be, decided by this Court; namely, whether items of prepaid income can be accounted for under federal tax laws in accordance with sound accounting principles. The confusion on this point arises from the failure of some lower courts to interpret correctly this Court's decision in *Automobile Club of Michigan* v. *Commissioner, supra.*

ARGUMENT

In deciding whether a petition for certiorari should be granted in this case, the first question this Court will undoubtedly ask is, "Did we not dispose of this issue in *Automobile Club of Michigan* v. *Commissioner*, 353 U.S. 180 (1957)?" Petitioner respectfully suggests the answer is, "No!"

One of the three issues involved in the *Automobile Club of Michigan* case did concern the method of accounting employed by that club with respect to prepaid membership dues. The Commissioner of Internal Revenue had disapproved the use of a method of accounting which reflected prepaid membership dues as income ratably over the period of a membership. The Commissioner argued that the "claim of right" doctrine required all prepaid dues to be reported as income entirely in the year of receipt, irrespective of principles of sound accrual accounting. While this Court referred to the "claim of right" doctrine, it seems clear the court did not ground its decision on that doctrine. Instead, in a 5-3 decision, this Court sustained the action of the Commissioner, the majority opinion explaining the reasons for the decision as follows:

> "The pro rata allocation of the membership dues in monthly amounts is purely artificial and bears no relation to the services which petitioner may in fact be called upon to render for the member . . . . We cannot say, *in the circumstances here*, that the discretionary action of the Commissioner, sustained by both the Tax Court and the Court of Appeals, exceeded permissible limits." (353 U.S. at 187) (Italics supplied).

The language quoted above has been interpreted by the lower courts in two vastly different ways, and much confusion exists as to its meaning.[1]

Petitioner's interpretation—and petitioner was familiar with the decision prior to the commencement of this litigation—was that the court's opinion by implication would allow a motor club to defer prepaid membership dues in accordance with sound accounting principles if a motor club could establish that its method of deferral bore a reasonable relationship to the future expenses which the club would incur in serving its members—and clearly reflected its income. In other words, if income and expense were matched, which is the essence of accrual accounting, deferral of prepaid dues would be permitted. By contrast, the Tax Court since *Automobile Club of Michigan* has reached the extreme conclusion that under no circumstances may an item of prepaid income ever be reported for tax purposes later than the year of receipt.[2]

The issue stated another way is: Was the Supreme Court decision in *Automobile Club of Michigan* grounded on a rule of law which overrides the governing statutes requiring the use of sound accounting or was the decision on the accounting issue based solely upon the facts which existed in that case? Since the record in the *Michigan Club* case was so devoid of evi-

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[1] A few of the most recent cases in this area are: *Bay Shore Gardens, Inc.* v. *Commissioner*, 267 F. (2d) 55 (2d Cir. 1959); *Bressner Radio, Inc.* v. *Commissioner*, 267 F. (2d) 520 (2d Cir. 1959); *Automobile Club of New York*, 32 T.C. 906 (1959); *Mark E. Schlude*, 32 T.C. 1271 (1959); *New Jersey Automobile Club* v. *U. S.*, 181 F. Supp. 259 (Ct. Cl. 1960); *Automobile Club of Southern California* v. *U. S.*, 60-1 USTC, ¶ 9274 (S.D. Cal. 1960); *Streight Radio & Television, Inc.*, 33 T.C. 127 (1959).

[2] *Automobile Club of New York*, 32 T.C. 906 (1959).

dence on the accounting issue (not one certified public accountant was called to testify) and since this Court distinguished on their facts two cases involving the same or a similar legal principle,[3] petitioner's interpretation is that this Court decided the accounting issue solely on the facts or lack of facts in that case.

If this Court in *Automobile Club of Michigan* intended to lay down a rule of law that, *irrespective of sound and accepted accounting practices,* no taxpayer who receives money in advance of the rendition of services for which the money is paid can ever postpone the recognition as income of such money beyond the taxable year of receipt, then petitioner concedes that its petition for writ of certiorari should be denied. This would be a very sweeping rule indeed, and it is hard to believe that this interpretation of *Automobile Club of Michigan* is correct.

The method of accounting employed by petitioner with respect to prepaid dues income, although undeniably similar to that employed by the Michigan Club, has *here* been established as accurate, since both prepaid dues and prepaid expenses are accounted for ratably over the period of a membership and since the method used clearly reflects its income in the opinion of the accounting profession. Commissioner Bennett of the Court of Claims, who heard petitioner's testimony, made the following findings of fact: [See R. 12-27].

(a) "Funds representing advances from customers or members of an organization are not income

[3] *Beacon Publishing Company* v. *Commissioner*, 218 F. (2d) 697 (10th Cir. 1955); *Schuessler* v. *Commissioner*, 230 F. (2d) 722 (5th Cir. 1956).

at the time received but constitute a liability until such time as goods are delivered or services are rendered or made available in accordance with the advance payment agreement. It is an undisputed principle of accounting that no revenue or income can emerge until goods are delivered or until services are rendered." (Finding 23).

(b) The petitioner's method of accounting with respect to prepaid dues income was in accord with generally accepted accounting principles and was the most realistic and practical method of accounting that it could have employed. (Findings 22, 25, 29).

(c) The taxpayer's method of accounting clearly reflected its income. (Finding 33).

(d) The Government's method of accounting is contrary to generally accepted accounting principles and practices. (Finding 24).

(e) The Government's method of accounting results in an overstatement of petitioner's surplus account in the amount of $1,358,003.10 as of December 31, 1953 and an overstatement of surplus in the amount of $1,634,840.81 as of December 31, 1954. (Finding 24).

(f) The Government's method of accounting for prepaid dues income does not reflect taxpayer's net income accurately. (Finding 24).

(g) No reputable certified public accountant would certify to the accuracy of petitioner's profit and loss statements or balance sheets if the Government's method of accounting for prepaid dues is forced upon petitioner. (Finding 24).

Some of these findings were not included by the Court of Claims in its findings of fact, but it did find the following facts:

"The plaintiff's costs for servicing members were substantially in proportion to membership from year to year with reasonable constancy from month to month. . . ." (Finding 30). [R. 83].

"The method of accounting employed by plaintiff during the years in issue has been used regularly by plaintiff since 1931 and is in accord with generally accepted commercial accounting principles and practices . . . ." (Finding 22). [R. 80].

"Had the plaintiff recognized, assigned and transferred to its gross income account its monthly receipts of dues collected in advance in the proportion to its cost of servicing all of its members each month, instead of ratably over the membership period of 12 months, the proportion of advance dues which would have been recognized and assigned to gross income during the years in issue herein would have been substantially the same as the gross income from dues as determined and reported by the plaintiff under the method of accounting actually employed." (Finding 26). [R. 82].

Despite the Commissioner's findings of fact, and for that matter its own findings, the Court of Claims held that, as a matter of law, petitioner's method of accounting was artificial for tax purposes because this Court had held a similar method to be artificial in *Automobile Club of Michigan*. The effect of this decision is to say that a taxpayer is foreclosed from establishing that his method of accounting is not artificial, that it clearly reflects his income, and that it is based on sound accounting principles.

The United States Court of Appeals for the Second Circuit has construed *Automobile Club of Michigan* in a manner diametrically opposed to the construction of that case adopted by the Court of Claims in the

case at bar. In *Bressner Radio, Inc.*, 267 F. (2d) 520 (1959), decided by the Court of Appeals for the Second Circuit two years subsequent to this Court's decision in *Automobile Club of Michigan, supra,* the issue involved was identical in principle to that presented in the case at bar. The taxpayer in *Bressner Radio, Inc.* sold television sets. It agreed to service the sets only if a separate service contract was entered into by the purchaser. The cost of the service contract was prepaid for twelve months. Taxpayer's obligation was to render whatever services were necessary to keep the television set in repair and such services, other than installation, were rendered only upon the request of the owner of the set. In keeping its books and records and in filing its tax returns the taxpayer recognized prepaid television service fees as income ratably over the period of the contract rather than entirely in the year of receipt. It proved, however, that its method of accounting was in accord with sound accounting principles and clearly reflected its income. Upon the basis of the facts established by the taxpayer, the Court held for the taxpayer. In referring to the decision of this Court on the accounting issue in *Automobile Club of Michigan, supra,* it stated:

> "It is apparent from the decision of the majority that at least for purposes of the decision of the case it assumed that a realistic deferral would have been permissible, and found only that no realistic deferral was made." 267 F. (2d) at 526.

The Court then went on to conclude that the taxpayer before it had not used an artificial method of deferral, stating:

> "Drawing on its experience with thousands of contracts it was demonstrated that it was subject

> to a reasonably uniform demand for services so that it could and did anticipate that the expenses incident to the performance which alone would entitle it to regard the sum received as earned would be distributed across the life of the contract. It therefore deferred revenues until they were earned and thus matched them with foreseeably related expenses which is the essential purpose of accrual accounting. *United States* v. *Anderson*, 1926, 269 U.S. 422, 46 S. Ct. 131, 70 L. Ed. 347." 267 F. (2d) at 528.

Since the petitioner in the case at bar established by clear and uncontradicted evidence that its method of accounting was not artificial and did clearly reflect its income, it would certainly have prevailed under the rule of law spelled out by the Court of Appeals for the Second Circuit in *Bressner Radio, Inc.* v. *Commissioner, supra.* Thus, that decision and the decision in the case at bar are in direct conflict. Furthermore, this conflict relates to an extremely important issue with respect to which much confusion exists in the courts below.[4] It should also be noted that, in the opinion of commentators and writers in the field, this crucial question has never been decided on its merits by this Court.[5]

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[4] See cases cited in n. 1, *supra.*

[5] "The Supreme Court implied that a realistic deferral would have been permissible and found only that no realistic deferral had been made. Thus, the issue of the inclusion of prepaid income, *properly allocated* to future periods, in current taxable income was not passed upon by the Supreme Court." Behren, "Prepaid Income Accounting Concepts and the Tax Law," 15 Tax L. Rev. 343, 359, 360 (1960). See also Costigan, "Accrual Accounting in the Courts of Appeals," 38 Taxes 339, 348-349 (1960); Jacobs, "Chang-

With respect to this important conflict it would appear clear from the statutory provisions involved that this Court, in, *Automobile Club of Michigan, supra*, could not have meant what the Court of Claims below has said it meant, but on the contrary, must have meant what the Court of Appeals for the Second Circuit in *Bressner Radio, Inc., supra,* said it meant.

Section 446 of the Internal Revenue Code of 1954 states, as did its predecessor, Section 41(a) of the Internal Revenue Code of 1939, that

> "Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income and keeps his books."

Exceptions to this general rule are provided for if no method of accounting has been regularly used by the taxpayer or if the method used does not clearly reflect income. The Commissioner of Internal Revenue is granted the power to change a taxpayer's method of accounting only if one of these two exceptions is applicable.

Similarly, Section 451 of the 1954 Code states as did its predecessor, Section 42 of the 1939 Code, that

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ing Attitudes Toward Accrual Concepts," N.Y.U. 16th Inst. on Fed. Tax, 579, 595 (1958).

In Note, "Taxation of Prepaid Income: A Temporary Solution," 67 Yale L.J. 1425, 1440 (1958) it is stated:

"... Thus, an automobile club could defend its method of allocating any individual's dues by demonstrating the average services requested by a member for a particular period."

See also Freeman, "Tax Accrual Accounting for Contested Items," 56 Mich. L. Rev. 727, 730-731, 737 (1958); Hoffman, "Accounting Treatment Counts in Determining Net Taxable Income," 35 Taxes 918, 921 (1957); Note, "Taxation: Prepaid Income Deferrals and the 'Claim of Right' Doctrine," 1960 Duke L.J. 127, 131-134; Note, 59 Col. L. Rev. 942, 944 (1959).

> "Any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, *unless under the method of accounting used in computing taxable income such amount is to be properly accounted for as of a different period.*" (Italics supplied).

The statutory language clearly states that the time at which items of gross receipts shall be included in gross income is determined by reference to the taxpayer's method of accounting. It seems obvious that a method of accounting is one which meets the approval of the accounting profession as clearly reflecting income. The Treasury's own regulations interpreting the statutory provisions quoted above reinforce this conclusion. These regulations state:

> "A method of accounting which reflects a consistent application of generally accepted accounting principles in a particular trade or business in accordance with accepted conditions in that trade or business would ordinarily be regarded as clearly reflecting income, providing all items of gross income are treated consistently from year to year." Treasury Regulations, Section 1.446-1(a)(2).

Once again deference to the accounting profession is obvious.

The Regulations under the 1939 Code contain the following statement:

> "Approved standard methods of accounting will ordinarily be regarded as clearly reflecting income." Treasury Regulations, Section 118, Section 39.41-2(a).

Petitioner submits that it is clear beyond doubt that a taxpayer should be entitled to use a method of ac-

counting if he establishes that such method clearly reflects his income and, in his situation, is not "artificial" but is "realistic," and taxpayers should not be precluded from using such method on the ground that this Court in *Automobile Club of Michigan* v. *Commissioner, supra* has ruled out such a method as a matter of law.

In summary, the grounds within this Court's rules upon which petitioner relies in this petition for a writ of certiorari are:

1. The decision below is in direct conflict with that of the Court of Appeals for the Second Circuit in *Bressner Radio, Inc.* v. *Commissioner, supra.*

2. A decision by this Court is needed to clarify an important question of federal income tax law which arises out of the diversity of interpretations by the lower courts of this Court's decision in *Automobile Club of Michigan* v. *Commissioner, supra.*

Moreover, it should be noted that the decision below is inconsistent with the primary findings of fact made by the Court of Claims. Such a situation calls for the exercise of this Court's power of supervision as in *United States* v. *Penn Foundry Manufacturing Co., Inc.*, 337 U.S. 198 (1949).

Respectfully submitted,

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APPENDIX

Internal Revenue Code 1939

"SEC. 41. GENERAL RULE.

"The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. * * *"

"SEC. 42. PERIOD IN WHICH ITEMS OF GROSS INCOME INCLUDED.

"(a) General Rule.—The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period. * * *"

Regulations 118

"§ 39.41-1 *Computation of net income.* Net income must be computed with respect to a fixed period. Usually that period is 12 months and is known as the taxable year. Items of income and of expenditure which as gross income and deductions are elements in the computation of net income need not be in the form of cash. It is sufficient that such items, if otherwise properly included in the computation, can be valued in terms of money. The time as of which any item of gross income or any deduction is to be accounted for must be determined in the light of the fundamental rule that the computation shall be made in such a

manner as clearly reflects the taxpayer's income. If the method of accounting regularly employed by him in keeping his books clearly reflects his income, it is to be followed with respect to the time as of which items of gross income and deductions are to be accounted for. (See §§ 39.42-1 to 39.42-3, inclusive.) If the taxpayer does not regularly employ a method of accounting which clearly reflects his income, the computation shall be made in such manner as in the opinion of the Commissioner clearly reflects it.

"39.41-2 *Bases of computation and changes in accounting methods.* (a) Approved standard methods of accounting will ordinarily be regarded as clearly reflecting income. A method of accounting will not, however, be regarded as clearly reflecting income unless all items of gross income and all deductions are treated with reasonable consistency. See section 48 for definitions of 'paid or accrued' and 'paid or incurred.' All items of gross income shall be included in the gross income for the taxable year in which they are received by the taxpayer, and deductions taken accordingly, unless in order clearly to reflect income such amounts are to be properly accounted for as of a different period. • • •

• • • •

"§ 39.42-1 *When included in gross income*—(a) *In general.* Except as otherwise provided in section 42, gains, profits, and income are to be included in the gross income for the taxable year in which they are received by the taxpayer, unless they are included as of a different period in accordance with the approved method of accounting followed by him. See §§ 39.41-1 to 39.41-3, inclusive. • • •"

Internal Revenue Code of 1954:

"SEC. 446. GENERAL RULE FOR METHODS OF ACCOUNTING.

"(a) General Rule.—Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.

"(b) Exceptions.—If no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary or his delegate, does clearly reflect income.

"(c) Permissible Methods.—Subject to the provisions of subsections (a) and (b), a taxpayer may compute taxable income under any of the following methods of accounting—

(1) the cash receipts and disbursements method;
(2) an accrual method;
(3) any other method permitted by this chapter; or
(4) any combination of the foregoing methods permitted under regulations prescribed by the Secretary or his delegate.

"(d) Taxpayer Engaged in More Than One Business.—A taxpayer engaged in more than one trade or business may, in computing taxable income, use a different method of accounting for each trade or business.

"(e) Requirement Respecting Change of Accounting Method.—Except as otherwise expressly provided in this chapter, a taxpayer who changes the method of accounting on the basis of which he regularly computes his income in keeping his books shall, before computing his taxable income under the new method, secure the consent of the Secretary or his delegate.

"SEC. 451. GENERAL RULE FOR TAXABLE YEAR OF INCLUSION.

"(a) General Rule.—The amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period.

"(b) Special Rule in Case of Death.—In the case of the death of a taxpayer whose taxable income is computed under an accrual method of accounting, any amount accrued only by reason of the death of the taxpayer shall not be included in computing taxable income for the period in which falls the date of the taxpayer's death."

Regulations Promulgated Under the 1954 Code:

"§ 1.446-1 (T.D. 6282, filed 12-24-57.)

"General rule for methods of accounting—(a) General rule. (1) Section 446(a) provides that taxable income shall be computed under the method of accounting on the basis of which a taxpayer regularly computes his income in keeping his books. The term 'method of accounting' includes not only the over-all method of accounting of the taxpayer but also the accounting treatment of any item. Examples of such over-all methods are the cash receipts and disbursements method, an accrual method, combinations of such methods, and combinations of the foregoing with various methods provided for the accounting treatment of special items. These methods of accounting for special items include the accounting treatment prescribed for research and experimental expenditures, soil and water conservation expenditures, depreciation, net operating losses, etc. Except for deviations permitted or required by such special accounting treatment, taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes

his income in keeping his books. For requirement respecting the adoption or change of accounting method, see section 446(e) and paragraph (e) of this section.

"(2) It is recognized that no uniform method of accounting can be prescribed for all taxpayers. Each taxpayer shall adopt such forms and systems as are, in his judgment, best suited to his needs. However, no method of accounting is acceptable unless, in the opinion of the Commissioner, it clearly reflects income. A method of accounting which reflects the consistent application of generally accepted accounting principles in a particular trade or business in accordance with accepted conditions or practices in that trade or business will ordinarily be regarded as clearly reflecting income, provided all items of gross income and expense are treated consistently from year to year.

"(3) Items of gross income and expenditures which are elements in the computation of taxable income need not be in the form of cash. It is sufficient that such items can be valued in terms of money. For general rules relating to the taxable year for inclusion of income and for taking deductions, see sections 451 and 461 and the regulations thereunder.

• • • •

"§ 1.451-1 (T.D. 6282 filed 12-24-57.)

"General rule for taxable year of inclusion—(a) General rule.—Gains, profits, and income are to be included in gross income for the taxable year in which they are actually or constructively received by the taxpayer unless includible for a different year in accordance with the taxpayer's method of accounting. Under an accrual method of accounting, income is includible in gross income when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy. Therefore, under such a method

of accounting if, in the case of compensation for services, no determination can be made as to the right to such compensation or the amount thereof until the services are completed, the amount of compensation is ordinarily income for the taxable year in which the determination can be made. Under the cash receipts and disbursements method of accounting, such an amount is includible in gross income when actually or constructively received. Where an amount of income is properly accrued on the basis of a reasonable estimate and the exact amount is subsequently determined, the difference, if any, shall be taken into account for the taxable year in which such determination is made. To the extent that income it attributable to the recovery of bad debts for accounts charged off in prior years, it is includible in the year of recovery in accordance with the taxpayer's method of accounting, regardless of the date when the amounts were charged off. For treatment of bad debts and bad debt recoveries, see sections 166 and 111 and the regulations thereunder. For rules relating to the treatment of amounts received in crop shares, see section 61 and the regulations thereunder. For the year in which a partner must include his distributive share of partnership income, see section 706(a) and § 1.706-1(a). If a taxpayer ascertains that an item should have been included in gross income in a prior taxable year, he should, if within the period of limitation, file an amended return and pay any additional tax due. Similarly, if a taxpayer ascertains that an item was improperly included in gross income in a prior taxable year, he should, if within the period of limitation, file claim for credit or refund of any overpayment of tax arising therefrom."

In the United States Court of Claims

No. 311-58

(Decided March 2, 1960)

AMERICAN AUTOMOBILE ASSOCIATION v. THE UNITED STATES

Mr. Fleming Bomar for the plaintiff. *Messrs. Joseph E. McAndrews* and *Irvine, Phillips & Barker* were on the brief.

Mr. Jerry M. Hanovit, with whom was *Mr. Assistant Attorney General Charles K. Rice*, for the defendant. *Messrs. James P. Garland* and *Lyle M. Turner* were on the brief.

OPINION

JONES, *Chief Judge*, delivered the opinion of the court:

The plaintiff, a motor club, seeks to recover Federal income taxes and assessed interest paid for the calendar years 1952 and 1953. The issue to be decided here involves the tax treatment to be accorded the prepaid income of an accrual basis taxpayer. The problem arises because club membership dues are paid to the taxpayer for 12 months in advance.

Plaintiff is a national organization which renders services to affiliated local automobile clubs and their members and performs services of a public nature in fields relating to motoring and travel. In addition to its activities as a national organization, the plaintiff operates directly, as divisions, ten local automobile clubs. A substantial portion of the annual gross income of plaintiff is derived from dues, prepaid for one year in advance, received from members of the automobile clubs operated as divisions of the plaintiff.

Plaintiff provides services for the members of the local divisions over the 12-month period following payment of

dues. These services, although not completely uniform, generally included the following: (a) A travel service which included trip planning, tour books, accommodation directories, maps and recommended routes; (b) emergency road service which consisted of towing, changing tires, replacing batteries and other minor repairs; the road service was provided by plaintiff through contracts made with garages and service stations in the areas served by its divisions; (c) bail bond protection up to $5,000 through contracts made by the plaintiff with bondsmen; (d) personal automobile accident insurance; (e) a theft reward offered by the plaintiff for information leading to the arrest and conviction of any person stealing a member's car; (f) in addition, the plaintiff, in one or more of its divisions, provided other personal services for members which included procuring motor licenses, notarial services, brake and headlight adjustments, and advice on how to prepare and file papers in small claims courts.

The prepaid dues collected from members of its divisions were deposited in plaintiff's bank accounts with no restrictions as to their use for any of its corporate purposes. However, the dues upon collection were reflected in a liability account designated "Deferred Revenue—Membership Dues." Thereafter, a pro rata part of the dues was removed from the liability account and reflected in an "income" account. Dues collected from members who joined in the month of January were recognized as income in January only to the extent of 1/24 (a half of 1/12) of such collections, on the assumption that the average or mean date of the January collections would be the middle of the month.[1] Thereafter, 1/12 of the dues collected in January was taken out of the liability account and credited to income in each of the following 11 months (i.e., February through December). The remaining 1/24 of the dues collected in January was kept as a liability in the "Deferred Revenue—Membership Dues" account on December 31, but was subsequently recognized as income for January of the following year.

[1] Plaintiff's taxable year was the calendar year.

Dues collected in each of the other months of the calendar year were treated in the same manner. That is, 1/24 of each month's collections was recognized as income in the first month of membership, 1/12 of the amount paid was recognized as income in each of the following eleven months, and the remaining 1/24 was allocated to income in the month when membership expired. Commencing in 1954, the plaintiff, in order to simplify internal accounting detail, changed its procedure in the monthly accounting for dues by assigning 50 percent of the dues to income for the current year and allocating the other 50 percent as a liability which matured as income in the following tax year.

In preparing its income tax returns for the years in suit, plaintiff, an accrual basis taxpayer, excluded from the income received in each year that portion of membership dues which remained in the liability account ("Deferred Revenue, Membership Dues") at the end of the taxable year. It thus treated dues as income ratably over the 12-month period of membership, whether or not such period extended beyond the close of its taxable year.

Expenses which plaintiff considered to fall within the category of prepaid membership costs, e.g., salesmen's commissions and the cost of accident insurance covering the period of a membership, even though paid by plaintiff, were not deducted entirely in the taxable year paid or incurred, but instead were deducted ratably over the same periods of time that dues were recognized as income.

The income reported by plaintiff in its tax return for the calendar year 1953 attributable to dues received from members of its divisions was $3,237,813.41, representing $1,562,042.23 of prepaid dues collected in 1952 but not recognized as income until 1953, plus $1,675,771.21 of dues collected in 1953 and recognized as income in that year.

For 1954, dues reported by plaintiff as income for purposes of the Federal income tax totaled $3,794,672.20, representing $1,755,107.46 of advance dues collected in 1953 but not recognized as income until 1954, plus $2,039,564.74 of dues collected in 1954 and recognized as income in that year.

Plaintiff claimed that as a result of a 1954 net operating loss in the amount of $289,987.67, it was entitled to a net operating loss carryback *deduction* in 1952 in the amount

of $154,411.11, and a net operating loss carryback *deduction* in 1953 in the amount of $135,556.56. Upon examination of the plaintiff's Federal income tax returns for the calendar years 1952, 1953, and 1954, the Commissioner of Internal Revenue disallowed plaintiff's deferral of income from one year to another, for years subsequent to 1953, thereby increasing plaintiff's 1954 net operating income from $353,279.09 to $481,557.59 and reducing plaintiff's 1954 net operating loss from $289,967.67 to $14,412.49. The net effect of the Commissioner's determination was to reduce plaintiff's net operating loss carryback deduction to $14,412.49 in 1952 and to eliminate entirely any net operating loss carryback deduction in 1953.

The issue to be decided by this court is whether the Commissioner of Internal Revenue correctly determined that plaintiff's method of accounting—with respect to dues received from members of its divisions—does not clearly reflect plaintiff's income within the meaning of § 41 of the Internal Revenue Code of 1939 and § 446 of the Internal Revenue Code of 1954. Section 41 required that "the net income shall be computed . . . in accordance with the method of accounting regularly employed in keeping the books . . . but . . . if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income . . . ."[2]

The Commissioner of Internal Revenue disallowed the deferral of income from one year to another on the ground that prepaid dues received under a "claim of right," without restriction as to their disposition, represents income in the year of *receipt* and should be taxed in that year regardless of the method of accounting employed by the taxpayer. This position is based on the claim of right doctrine enunciated by the Supreme Court in *North American Oil Co.* v. *Burnet*, 286 U.S. 417, 424 (1932). It is of course fairly obvious that, once it is determined that prepaid income is

[2] To the same effect, § 446, Int. Rev. Code of 1954, provides that: "Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books." However, "if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary or his delegate, does clearly reflect income."

required to be included in income in the year of receipt under the claim of right doctrine, it would necessarily follow that any other method of reporting would not "clearly reflect the income."

The opposite view, advanced by the plaintiff—that the claim of right doctrine does not relate to the question whether items that admittedly belong to the taxpayer may be attributed to a taxable year other than that of receipt in accordance with principles of accrual accounting—has been succinctly presented by Mr. Justice Harlan, dissenting in *Automobile Club of Michigan* v. *Commissioner*, 353 U.S. 180, 191–192 (1957).[8]

However, we do not find it necessary to resolve this issue, since we agree with the Government's contention that the method of treatment of prepaid automobile club membership dues employed by the plaintiff was dealt with by the Supreme Court in *Automobile Club of Michigan* v. *Commissioner*, 353 U.S. 180, rehearing denied, 353 U.S. 989 (1957), and was held to be, at least for Federal income tax purposes, "purely artificial." In the *Automobile Club of Michigan* case prepaid membership dues were credited upon receipt to an account carried as a liability and designated "Unearned Membership Dues." - "*During the first month of membership and each of the following eleven months one-twelfth of the amount paid . . .* [was] *'credited to an account designated 'Membership Income.'* This method of accounting was followed by petitioner [a motor club] from 1934. The income from such dues reported by petitioner in each of its tax returns for 1943 through 1947 was the amount credited in the year to the 'Membership Income' account." 353 U.S. at 188. (Emphasis supplied.)

The Commissioner of Internal Revenue had determined that this method of accounting—which is essentially the same method used by the plaintiff in the case at bar—did not clearly reflect income. The Supreme Court, in affirming the action of the Commissioner, stated (353 U.S. at 189–190):

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[8] "[The claim of right] doctrine, it seems to me, comes into play only in determining whether the treatment of an item of income should be influenced by the fact that the right to receive or keep it is in dispute; it does not relate to the entirely different question whether items that admittedly belong to the taxpayer may be attributed to a taxable year other than that of receipt in accordance with principles of accrual accounting." (*Automobile Club of Michigan* v. *Commissioner*, 353 U.S. 180, 191–192 (dissenting opinion) (1957).)

> The petitioner does not deny that it has the unrestricted use of the dues income in the year of receipt, but contends that its accrual method of accounting clearly reflects its income and that the Commissioner is therefore bound to accept its method of reporting membership dues. We do not agree. * * * *The pro rata allocation of the membership dues in monthly amounts is purely artificial and bears no relation to the services which petitioner may in fact be called upon to render for the member.* Section 41 vests the Commissioner with discretion to determine whether the petitioner's method of accounting clearly reflects income. We cannot say, in the circumstances here, that the discretionary action of the Commissioner, sustained by both the Tax Court and the Court of Appeals, exceeded permissible limits. See *Brown* v. *Helvering*, 291 U.S. 193, 204-205. [Emphasis supplied.]

Although it would appear that *Automobile Club of Michigan* does not expressly rule out deferral of income,[4] we are constrained to interpret this language as a rejection by the Supreme Court of the accounting method advanced by plaintiff in the case at bar.

We are influenced in our decision by the language used by the Court to distinguish on their facts *Beacon Publishing Co.* v. *Commissioner*, 218 F. 2d 697 (10th Cir. 1955) (deferral of prepaid magazine subscription income) and *Schuessler* v. *Commissioner*, 230 F. 2d 722 (5th Cir. 1956) (reserves set up to meet future costs):

> In *Beacon*, performance of the subscription, in most instances, was, in part, *necessarily* deferred until the publication dates after the tax year. In *Schuessler*, performance of the service agreement required the taxpayer to furnish services at *specified times* in years subquent to the tax year. In this case [as in the case at bar], substantially all services are performed only upon a *member's* demand and the taxpayer's performance was not related to *fixed dates* after the tax year. We express no opinion upon the correctness of the decisions in *Beacon* or *Schuessler*.[5]

But regardless of the underlying basis for the Court's rejection of "the pro rata allocation of the membership dues

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[4] See *Automobile Club of Michigan* v. *Commissioner*, 353 U.S. at 192-193 (dissenting opinion).

[5] *Automobile Club of Michigan* v. *Commissioner*, 353 U.S. at 189, fn. 20. (Emphasis supplied.)

in monthly amounts" as "purely artificial," we feel constrained by the decision in *Automobile Club of Michigan* to reject that same method of accounting for tax purposes in the case at bar.*

The plaintiff is therefore not entitled to recover and its petition will be dismissed.

It is so ordered.

LITTLETON, *Judge (Ret.)*; LARAMORE, *Judge*, and MADDEN, *Judge*, concur.

WHITAKER, *Judge*, concurring:

From the enactment of the Corporation Excise Tax Act of 1909 and the first income tax act in 1913, it has been universally supposed that in order to "clearly reflect income" the taxpayers' accounting method must treat as gross income amounts received or accrued in the taxable year, with certain exceptions specified in the Code. The income under consideration here was received in plaintiff's taxable year. Plaintiff's method of accounting treats a portion of that income as not having been received in the taxable year and, thus, does not clearly reflect its income, unless it comes within the statutory exceptions. Those exceptions are, for example, reserves for depreciation, obsolescence, and depletion, and, in the case of insurance companies prepaid premium reserves. The statute does not allow the deduction of reserves to anticipate expenses of meeting the demands of plaintiff's membership. What plaintiff, in effect, seeks to do is to deduct such a reserve from the income it received within the taxable year.

I also concur in the majority opinion.

FINDINGS OF FACT

The court, having considered the evidence, the report of Trial Commissioner Marion T. Bennett, and the briefs and argument of counsel, makes findings of fact as follows:

1. Plaintiff is a corporation with its principal office at 1712 G Street, Northwest, Washington, D.C. Plaintiff was incorporated in the year 1910 under the laws of the State of

*Cf. *Brosnick Radio, Inc.* v. *Commissioner*, 267 F. 2d 529, 528, 529 (2d Cir. 1959); *Automobile Club of Southern California* v. *United States*, Civil No. 1169-58, S. D. Cal., January 22, 1960.

Connecticut and was organized and is operated as a non-stock, membership corporation.

2. Plaintiff is a national organization which renders services to affiliated local automobile clubs and their members and performs services of a public nature in fields relating to motoring and travel.

3. In addition to the activities described in paragraph two above, plaintiff operates directly, as divisions, the following local automobile clubs:

District of Columbia Division of AAA (Metropolitan area, Washington, D. C.)
Louisiana Division of AAA (entire state)
Massachusetts Division of AAA (part of state)
New Hampshire Division of AAA (entire state)
New Mexico Division of AAA (entire state)
North Florida Division of AAA, South Florida Division of AAA (part of state)
Texas Division of AAA (part of state)
Wisconsin Division of AAA (entire state)
Wyoming Division of AAA (entire state)

4. A substantial portion of the annual gross income of plaintiff is derived from dues, prepaid for one year in advance, received from members of the automobile clubs described in paragraph three and operated as divisions of plaintiff. Plaintiff provides services for such members over the 12-month period following payment of dues. The services provided by plaintiff for the members of its divisions during the years in issue, although tending to be parallel, were not completely uniform and included the following: (a) A complete travel service which included trip planning, tour books, accommodation directories, maps and recommended routes. (b) Emergency road service which consisted of towing, changing tires, replacing batteries and other minor repairs. The road service was provided by plaintiff through contracts made with garages and service stations in the areas served by its divisions. (c) Bail bond protection up to $5,000 through contracts made by the plaintiff with bondsmen. (d) Personal automobile accident insurance which included hospitalization, personal injury and death benefits on a sliding scale in the event of a motoring accident. The plaintiff contracted for the insurance on a group basis and paid the premiums on the group policies.

(e) A theft reward offered by the plaintiff for information leading to the arrest and conviction of any person stealing a member's car. In addition, the plaintiff, in one or more of its divisions, provided other personal services for members which included procuring motor licenses, notarial services, brake and headlight adjustments, and advice on how to prepare and file papers in small claims courts.

5. In order to make available and provide for the members of its divisions the services which plaintiff provides, plaintiff during the years in issue owned or rented offices in 39 to 41 different geographical locations and had on its divisions' payroll 495 employees in December 1953 and 603 employees in December 1954.

6. Plaintiff, commencing with the calendar year 1943, has been required to file Federal income tax returns and to pay Federal income taxes on its net income. Its Federal income tax returns are filed with the District Director of Internal Revenue, Baltimore, Maryland. The plaintiff's taxable year is the calendar year.

7. Plaintiff employs the accrual method of accounting in keeping its books and records and in filing its Federal income tax returns.

8. Plaintiff, within the time prescribed by law, filed Federal income tax returns with the District Director of Internal Revenue, Baltimore, Maryland, for the calendar years 1952, 1953 and 1954. The 1952 return reported a net income of $152,975.51, the 1953 return reported a net income of $35,125.86, and the 1954 return reported a net operating loss in the amount of $289,186.04.

9. Upon examination of plaintiff's Federal income tax returns for the calendar years 1952, 1953 and 1954, the Commissioner of Internal Revenue made several minor adjustments which are not in issue in this proceeding, the net effect of which was to increase plaintiff's 1952 net income to $154,411.11, to increase plaintiff's 1953 net income to $353,279.09, and to reduce plaintiff's 1954 net operating loss to $289,867.67.

10. Plaintiff claimed that as a result of its 1954 net operating loss in the amount of $289,867.67, it was entitled to a net operating loss carryback deduction in 1952 in the

amount of $154,411.11, and a net operating loss carryback deduction in 1953 in the amount of $135,556.56.

11. Upon examination of plaintiff's Federal income tax returns for the calendar years 1952, 1953 and 1954, the Commissioner of Internal Revenue also determined not to recognize the method of accounting employed by plaintiff in computing its income derived from prepaid dues collected from members of its divisions during the calendar years 1953 and 1954, which is the issue in this proceeding. The net effect of such determination was to increase plaintiff's 1953 net income from $353,279.09 to $481,557.59 and to reduce plaintiff's 1954 net operating loss from $289,967.67 to $14,412.49, with the further result that the Commissioner reduced plaintiff's net operating loss carryback deduction from $154,411.11 to $14,412.49 in 1952 and eliminated entirely any net operating loss carryback deduction in 1953.

12. The Commissioner of Internal Revenue determined the increase of plaintiff's income for 1953 by $128,278.50 and the reduction of plaintiff's loss for 1954 by $275,555.15 was in the following manner:

	1953 Adjustments	1954 Adjustments
Reserve for unearned and deferred income Dec. 31 of current year	$1,756,485.46	$2,039,264.43
Less reserve for unearned and deferred income Dec. 31 of prior year	1,562,042.23	1,756,485.46
Difference	194,443.23	282,778.97
Less		
Prepaid commissions		
Dec. 31 of current year	398,482.36	405,708.15
Dec. 31 of prior year	332,317.63	398,482.36
Difference	66,164.73	7,225.79
Net additional income determined for the current year	128,278.50	275,555.18

All of the foregoing items are reflected in the plaintiff's balance sheets as of December 31 for the years involved, which were filed with its income tax returns for 1953 and 1954. The liabilities contain the account UNEARNED AND DEFERRED INCOME, and the assets contain the account PREPAID COMMISSIONS, but the latter account is not involved in the

items labeled prepaid commissions in the above tabulation. The deduction items employed by the Commissioner of the Internal Revenue Service represent plaintiff's asset account for prepaid membership costs. The plaintiff's assets for 1954 do not reflect any amount for prepaid membership costs, but its liabilities for unearned and deferred income reflect the approximate net difference between $2,039,264.43 and $405,706.15 in its 1954 balance sheet.

13. As a result of the adjustments described heretofore, the Commissioner of Internal Revenue on May 15, 1956, asserted an income tax deficiency against plaintiff in the amount of $58,083.58 for the calendar year 1952, and in the amount of $137,907.48 for the calendar year 1953. These deficiencies in tax, plus interest of $2,019.37 for the year 1952 and $10,789.77 for the year 1953, were paid by plaintiff on May 25, 1956, and May 28, 1956.

14. On May 10, 1958, plaintiff filed timely claims for refund for each of the years in suit, which claims for refund raised the issues upon which plaintiff now seeks recovery in this action. On July 1, 1958, the Commissioner of Internal Revenue notified plaintiff by registered letter that its claims for refund had been denied.

15. Plaintiff, a nonstock, membership corporation, obtained substantially all of the funds necessary to carry on the operation of its divisions by dues from its members, paid for one year in advance.

16. Under the method of accounting employed by plaintiff during the years in issue, prepaid dues collected from members of its divisions were not regarded entirely as income for accounting purposes in the calendar year of receipt, but instead prepaid dues were recognized and treated as income ratably over the 12-month membership period whether or not such period extended beyond the close of plaintiff's taxable year.

As of December 31 of each taxable year, the proportion of dues collected within the year which was applicable under plaintiff's system of accounting to memberships extending beyond the close of the taxable year was considered and recorded as a liability of plaintiff and was reflected on plaintiff's balance sheet with its tax return as a liability.

Expenses which plaintiff considered to fall within the category of prepaid membership costs, e.g., salesmen's commissions, and the cost of accident insurance covering the period of a membership, even though paid by plaintiff, were not deducted entirely in the taxable year paid or incurred, but instead were deducted ratably over the same periods of time that dues were recognized as income.

17. During the calendar years 1953 and 1954, plaintiff recorded on its books and records, by months, the following amounts of prepaid dues collected from members of its divisions:

	1953	1954
January	$257,098.02	$290,764.23
February	236,610.67	284,319.95
March	282,459.08	351,697.47
April	298,647.02	329,088.99
May	328,191.75	382,395.28
June	378,716.30	451,269.61
July	386,150.87	435,832.98
August	336,269.68	395,009.70
September	275,235.54	280,959.54
October	269,681.48	309,543.51
November	219,278.02	279,144.64
December	263,289.26	308,553.22
	3,331,178.67	4,078,529.17

This money was deposited in plaintiff's bank accounts with no restrictions as to its use for any of its corporate purposes.

Section 4 of the bylaws of the American Automobile Association specifically provided for the use of funds and reads as follows:

> SECTION 4. (*Use of Funds*) This corporation shall use its funds only to accomplish the objects and purposes specified in Section 3, and no part of said funds shall inure, or be distributed, to the members of this corporation. On dissolution the funds of the corporation shall be distributed to one or more regularly organized charitable organizations to be selected by the Board of Directors.

18. Under the accounting system employed by the plaintiff from 1931 through 1953 prepaid dues collected from members who joined in the month of January were recognized as income in January to the extent of 1/24 of such collections, on the assumption that the average or mean date would be

the middle of the month. Thereafter, 1/12 of prepaid collections for January was transferred or allocated to income for each of the following 11 months, and 1/24 of January collections remained a liability on December 31 and was transferred and recognized as income for January of the following year.

Prepaid dues for each month of the calendar year were treated in the same manner, that is, 1/24 of such collections was transferred and recognized as income in the current month when collections were made, 1/12 of such collections during the following 11 months and 1/24 thereof in the last month when membership expired. The monthly collections of prepaid dues during a calendar year which were recognized and transferred to income during the current year and the portion thereof remaining in the liability account at the end of the year, which was entitled DEFERRED REVENUE MEMBERSHIP DUES, UNEARNED AND DEFERRED INCOME or some similar title, appear in the following tabulation:

	Portion Treated as Income for the Current Year	*Portion Remaining in the Liability Account Dec. 31 and Treated as Income the Following Year*
January	23/24	1/24
February	21/24	3/24
March	19/24	5/24
April	17/24	7/24
May	15/24	9/24
June	13/24	11/24
July	11/24	13/24
August	9/24	15/24
September	7/24	17/24
October	5/24	19/24
November	3/24	21/24
December	1/24	23/24

The allocation of prepaid dues each month facilitated the preparation of monthly statements of income and expenses. Had monthly collections been equal for each month during a year, the amount recognized as income during the current year and the amount remaining as a liability at the end of the year would have been equal under the foregoing apportionments.

19. Under the method of accounting employed by plaintiff, the proportion existing between dues collected from members of its divisions within a calendar year, which dues

were recognized as income during such year, and the proportion of such dues regarded as a liability at the end of such year was as follows for the calendar years 1949 through 1954:

	Portion Recognized as Income During the Year Collected	Portion Remaining in the Liability Account Dec. 31 and Treated as Income the Following Year
1949	49.9%	50.1%
1950	50.0%	50.0%
1951	50.2%	49.8%
1952	50.6%	49.4%
1953	50.3%	49.7%
1954	50.0%	50.0%

20. Commencing in 1954, in order to simplify much internal detail, the plaintiff changed its procedure in the monthly accounting for prepaid dues by the assignment of 50 percent to income for the current year and 50 percent as a liability which matured as income for the following year.

Plaintiff also adjusted certain inconsistencies in its prepaid expense account in 1954. Some division managers were paid a straight salary, whereas others were paid a nominal salary plus incentive commissions based upon the number of members within the division. These incentive commissions had been previously charged to the prepaid expense account and prorated over membership periods, whereas such incentive pay was actually a part of the manager's compensation. It was treated as current expense in 1954 and thereafter. Also, guaranteed commissions to new salesmen for a certain limited period had been included with commissions earned on subscriptions obtained, as prepaid expense, and beginning in 1954 such unearned guaranteed payments were charged to current expenses.

The plaintiff continued the apportionment of prepaid dues collected and prepaid expenses for commissions and insurance over the period of membership as it had done previously. The basic method of accounting employed by plaintiff in 1954 was consistent with that employed by plaintiff in 1953 and prior years.

21. The income reported by plaintiff in its tax return for the calendar year 1953 attributable to dues received from members of its divisions was $3,337,813.44, representing $1,562,042.23 of prepaid dues collected in 1952 but not recog-

nized as income until 1953, plus $1,775,771.21 of dues collected in 1953 and recognized as income in that year.

For 1954, dues reported by plaintiff as income for purposes of the Federal income tax totaled $3,794,672.20, representing $1,755,407.46 of advance dues collected in 1953 but not recognized as income until 1954, plus $2,039,264.74 of dues collected in 1954 and recognized as income in that year.

22. The method of accounting employed by plaintiff during the years in issue has been used regularly by plaintiff since 1931 and is in accord with generally accepted commercial accounting principles and practices and was, prior to the adverse determination by the Commissioner of the Internal Revenue, customarily and generally employed in the motor club field.[1]

The Internal Revenue Service did not question the method of accounting employed by plaintiff in computing its net income until the calendar year 1954, at which time deficiencies were proposed for the calendar years 1950, 1951 and 1952, but plaintiff was not required to pay those deficiencies by reason of a compromise settlement.

23. The determination of additional income by the Commissioner of the Internal Revenue Service for the taxable years involved herein was made by including as income the advance payment of dues covering membership benefit periods in the following year and excluding those payments received in the prior year that covered membership benefit periods in the current year.

By taking into income for the current year the amount which plaintiff treated as a liability for servicing membership periods in the following year, the amount of such receipts would be reflected in the plaintiff's surplus account at the end of the current year. The plaintiff's balance sheet as of December 31, 1953, filed with its tax returns for 1953

[1] Defendant offered no testimony. Plaintiff's testimony consisted of that of its staff auditors supplemented by outstanding certified public accountants testifying as experts who were, also, either familiar with plaintiff's problem or had some direct association with it and whose qualifications were not challenged. They were: *Dr. Wm. A. Paton*, for 44 years a professor of accounting and economics at the University of Michigan and an author and consultant on accounting. *George E. Baker*, Washington, D.C., resident partner of Ernst and Ernst, Certified Public Accountants. *Herbert T. McAuley*, a general and managing partner of Ernst and Ernst. *E. Alexander Bell*, partner in Peat, Marwick, Mitchell & Co., largest firm of Certified Public Accountants in the world.

and 1954 reflecting the items involved, is compared with the balance sheet which would result from the adjustments by the Commissioner of the Internal Revenue Service in the following table:

	Balance Sheet on December 31, 1953	
	(a) Reported by the Plaintiff	(b) Reflecting the Adjustments by the Commissioner of IRS
ASSETS:		
Cash	$1,941,723.88	$1,941,723.88
Prepaid membership cost	398,482.36	----------
Prepaid commissions	177,079.51	177,079.51
All other accounts, net	2,834,525.72	2,834,525.72
Total assets	5,351,811.47	4,953,329.11
LIABILITIES:		
Unearned and deferred income	1,756,485.46	----------
All other liabilities	1,063,462.99	1,063,462.99
Total liabilities	2,819,948.45	1,063,462.99
SURPLUS	2,531,863.02	3,889,866.12

24. The defendant contends that the sole issue is whether the Commissioner of Internal Revenue erred in refusing to allow plaintiff to defer a portion of income actually received, without any restriction as to its use, from the year in which it was received to the following year when services might have to be performed under the membership contracts.

The plaintiff's gross income from dues was measured by collections for the period memberships were in effect during the current year. This included pro rata amounts of prepaid dues collected in the prior year covering membership periods that extended into the current year, but excluded prepaid dues collected in the current year for membership periods that extended into the following year. The membership service costs and other operating expenses paid or incurred during the current year were then deducted from such gross income for its determination of net income.

25. Restrictions on the use of funds represented by prepaid dues were not required or intended by the plaintiff's members. On the contrary, the receipt of prepaid dues from members constituted the principal source of plaintiff's operating funds as heretofore found. Funds from other sources,

such as sales of publications, materials and supplies, advertising, etc., were normally received only after the costs and expenses were incurred in producing such revenues.

There is no evidence that membership contracts, or certificates issued by plaintiff to its members, provided any restriction in the use of funds received by plaintiff for dues paid in advance. Plaintiff's financial responsibility is not questioned.

26. The plaintiff prepared and submitted tabulations of the aggregate costs incurred by all of its divisions in servicing all members thereof for each month of each year from 1948 through 1954. These tabulations were received as plaintiff's exhibits 2 through 7, inclusive.

Had the plaintiff recognized, assigned and transferred to its gross income account its monthly receipts of dues collected in advance in the proportion to its cost of servicing all of its members each month, instead of ratably over the membership period of 12 months, the proportion of advance dues which would have been recognized and assigned to gross income during the years in issue herein would have been substantially the same as the gross income from dues as determined and reported by the plaintiff under the method of accounting actually employed.

27. The proportions of prepaid dues transferred and assigned to gross income by the plaintiff on a pro rata monthly time basis are compared with the proportion of assignments under the average monthly cost bases for servicing memberships in the following table:

	Plaintiff's Pro Rata Method as Reported	*Average Monthly Costs for Current Year*	*Average Monthly Costs Over Prior 5-Year Period*
1953			
Apportioned to Gross Income during current year	50.3%	49.8%	50.4%
Deferred to the Following Year (reported as a liability at the end of the current year)	49.7%	50.2%	49.6%
1954			
Apportioned to Gross Income during the current year	50.0%	48.8%	51.0%
Deferred to the following year (reported as a liability at the end of the current year)	50.0%	51.2%	49.0%

In the United States Court of Claims

No. 311-58

(Filed JUL 16 1959)

AMERICAN AUTOMOBILE ASSOCIATION v. THE UNITED STATES

REPORT OF COMMISSIONER

To the Honorable the CHIEF JUDGE AND ASSOCIATE JUDGES OF THE UNITED STATES COURT OF CLAIMS:

Pursuant to the order of reference in the above-entitled case, the undersigned Commissioner makes the following report of his findings of fact:

1. Plaintiff is a corporation with its principal office at 1712 G Street, Northwest, Washington, D.C. Plaintiff was incorporated in the year 1910 under the laws of the State of Connecticut and was organized and is operated as a non-stock, membership corporation.

2. Plaintiff is a national organization which renders services to affiliated local automobile clubs and their members and performs services of a public nature in fields relating to motoring and travel.

3. In addition to the activities described in paragraph two above, plaintiff operates directly, as divisions, the following local automobile clubs:

District of Columbia Division of AAA
(Metropolitan area, Washington, D. C.)
Louisiana Division of AAA (entire state)
Massachusetts Division of AAA (part of state)
New Hampshire Division of AAA (entire state)
New Mexico Division of AAA (entire state)
North Florida Division of AAA
South Florida Division of AAA } (part of state)
Texas Division of AAA (part of state)
Wisconsin Division of AAA (entire state)
Wyoming Division of AAA (entire state)

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4. A substantial portion of the annual gross income of plaintiff is derived from dues, prepaid for one year in advance, received from members of the automobile clubs described in paragraph three and operated as divisions of plaintiff. Plaintiff is obligated to provide services for such members over the 12-month period following payment of dues. The services provided by plaintiff for the members of its divisions during the years in issue, although tending to be parallel, were not completely uniform and included the following: (a) A complete travel service which included trip planning, tour books, accommodation directories, maps and recommended routes. (b) Emergency road service which consisted of towing, changing tires, replacing batteries and other minor repairs. The road service was provided by plaintiff through contracts made with garages and service stations in the areas served by its divisions. (c) Bail bond protection up to $5,000 through contracts made by the plaintiff with bondsmen. (d) Personal automobile accident insurance which included hospitalization, personal injury and death benefits on a sliding scale in the event of a motoring accident. The plaintiff contracted for the insurance on a group basis and paid the premiums on the group policies. (e) A theft reward offered by the plaintiff for information leading to the arrest and conviction of any person stealing a member's car. In addition, the plaintiff, in one or more of its divisions, provided other personal services for members which included procuring motor licenses, notarial services, brake and headlight adjustments, and advice on how to prepare and file papers in small claims courts.

5. In order to make available and provide for the members of its divisions the services which plaintiff contracted to provide, plaintiff during the years in issue owned or rented offices in 39 to 41 different geographical locations and had on its divisions' payroll 495 employees in December 1953 and 603 employees in December 1954.

6. Plaintiff, commencing with the calendar year 1943, has been required to file Federal income tax returns and to pay Federal income taxes on its net income. Its Federal income tax returns are filed with the District Director of Internal Revenue, Baltimore, Maryland. The plaintiff's taxable year is the calendar year.

7. Plaintiff employs the accrual method of accounting in keeping its books and records and in filing its Federal income tax returns.

8. Plaintiff, within the time prescribed by law, filed Federal income tax returns with the District Director of Internal Revenue, Baltimore, Maryland, for the calendar years 1952, 1953 and 1954. The 1952 return reported a net income of $152,975.51, the 1953 return reported a net income of $352,125.84, and the 1954 return reported a net operating loss in the amount of $290,186.04.

9. Upon audit of plaintiff's Federal income tax returns for the calendar years 1952, 1953 and 1954, the Commissioner of Internal Revenue made several minor adjustments which are not in issue in this proceeding, the net effect of which was to increase plaintiff's 1952 net income to $154,411.11, to increase plaintiff's 1953 net income to $353,279.09, and to reduce plaintiff's 1954 net operating loss to $289,967.67.

10. Plaintiff claimed that as a result of its 1954 net operating loss in the amount of $289,967.67, it was entitled to a net operating loss carryback deduction to 1952 in the amount of $154,411.11, and a net operating loss carryback deduction to 1953 in the amount of $135,556.56.

11. Upon audit of plaintiff's Federal income tax returns for the calendar years 1952, 1953 and 1954, the Commissioner of Internal Revenue also determined not to recognize the method of accounting employed by plaintiff in computing its income derived from prepaid dues collected from members of its divisions during the calendar years 1953 and 1954, which is the issue in this proceeding. The net effect of such determination was to increase plaintiff's 1953 net income from $353,279.09 to $481,557.59 and to reduce plaintiff's 1954 net operating loss from $289,967.67 to $14,412.49, with the further result that the Commissioner reduced plaintiff's net operating loss carryback deduction from $154,411.11 in 1954 to $14,412.49 in 1952 and eliminated entirely any net operating loss carryback deduction from 1954 to 1953.

12. The Commissioner of Internal Revenue determined the increase of plaintiff's income for 1953 by $128,278.50 and

the reduction of plaintiff's loss for 1954 by $275,555.15 was in the following manner:

	1953 Adjustments	1954 Adjustments
Reserve for unearned and deferred income Dec. 31 of current year	$1,736,485.46	$2,039,264.43
Less reserve for unearned and deferred income Dec. 31 of prior year	1,562,042.23	1,736,485.46
Difference	194,443.23	282,778.97
Less		
Prepaid commissions:		
Dec. 31 of current year	398,482.36	405,706.15
Dec. 31 of prior year	332,317.63	398,482.36
Difference	66,164.73	7,223.79
Net additional income determined for the current year	128,278.50	275,555.18

All of the foregoing items are reflected in the plaintiff's balance sheets as of December 31 for the years involved, which were filed with its income tax returns for 1953 and 1954. The liabilities contain the account UNEARNED AND DEFERRED INCOME, and the assets contain the account PREPAID COMMISSIONS, but the latter account is not involved in the items labeled prepaid commissions in the above tabulation. The deduction items employed by the Commissioner of the Internal Revenue Service represent plaintiff's asset account for prepaid membership costs. The plaintiff's assets for 1954 do not reflect any amount for prepaid membership costs, but its liabilities for unearned and deferred income reflect the approximate net difference between $2,039,264.43 and $405,706.15 in its 1954 balance sheet.

12. As a result of the adjustments described heretofore, the Commissioner of Internal Revenue on May 15, 1956, asserted an income tax deficiency against plaintiff in the amount of $56,083.58 for the calendar year 1952, and in the amount of $137,907.48 for the calendar year 1953. These deficiencies in tax, plus interest of $2,019.37 for the year 1952 and $10,789.77 for the year 1953, were paid by plaintiff on May 25, 1956, and May 28, 1956.

14. On May 10, 1958, plaintiff filed timely claims for refund for each of the years in suit, which claims for refund raised the issues upon which plaintiff now seeks recovery in this action. On July 1, 1958, the Commissioner of Internal Revenue notified plaintiff by registered letter that its claims for refund had been denied.

15. Plaintiff, being a nonstock, membership corporation, obtained substantially all of the funds necessary to carry on the operation of its divisions by advances from its members, i.e., dues prepaid for one year in advance in consideration of services to be rendered by plaintiff over the ensuing 12-month period.

Plaintiff's balance sheets filed with its 1953 and 1954 income tax returns reflect cash on hand December 31, 1953, of $1,941,723.88 and dues paid in advance of $1,756,485.46. The excess of $185,238.42 would represent cash received from other sources. However, on December 31, 1954, the dues collected in advance and reported in plaintiff's balance sheet at $1,634,840.81 exceeded the cash on hand of $1,502,478.97 by the sum of $132,361.84.

16. Under the method of accounting employed by plaintiff during the years in issue, advance dues collected from members of its divisions were not regarded entirely as income for accounting purposes in the calendar year of receipt, but instead advance dues were recognized and treated as income ratably over the 12-month period during which plaintiff was obligated to render services to such members whether or not such period extended beyond the close of plaintiff's taxable year.

As of December 31 of each taxable year, the proportion of advance dues, collected within the year applicable to membership contracts extending beyond the close of the taxable year and for which services had not yet been rendered or made available, was considered and recorded as a liability of plaintiff and was reflected on plaintiff's balance sheet with its tax return as a liability.

Expenses which plaintiff considered to fall within the category of prepaid membership costs, i.e., salesmen's commissions, and the cost of accident insurance covering the period of a membership, even though paid by plaintiff, were not

deducted entirely in the taxable year paid or incurred, but instead were deducted ratably over the same periods of time that advance dues were recognized as income.

17. During the calendar years 1953 and 1954, plaintiff recorded on its books and records, by months, the following amounts of prepaid or advance dues collected from members of its divisons:

	1953	1954
January	$237,698.02	$290,764.23
February	236,610.67	284,319.95
March	282,430.08	351,697.47
April	286,647.62	329,691.90
May	328,191.75	382,385.38
June	378,736.30	451,200.81
July	386,150.87	435,852.93
August	336,202.01	395,009.70
September	275,235.54	290,150.34
October	268,031.48	309,543.51
November	219,278.02	279,144.44
December	265,289.26	308,753.22
	3,531,178.07	4,095,529.17

This money was deposited in plaintiff's bank accounts with no restrictions as to its use for any of its corporate purposes. It was, in fact, prepaid financing by the members for the corporation's operating funds, including the cost of services to be performed during the following 12-month period of membership, as reported in finding 15 herein.

Section 4 of the bylaws of the American Automobile Association specifically provided for the use of funds and reads as follows:

> SECTION 4. (*Use of Funds*) This corporation shall use its funds only to accomplish the objects and purposes specified in Section 3, and no part of said funds shall inure, or be distributed, to the members of this corporation. On dissolution the funds of the corporation shall be distributed to one or more regularly organized charitable organizations to be selected by the Board of Directors.

18. Prepaid dues were true liabilities of the plaintiff at the time they were collected. Under the accounting system employed by the plaintiff from 1931 through 1953 advance dues collected from members who joined in the month of

January were recognized as income in January to the extent of 1/24 of such collections, on the assumption that the average or mean date would be the middle of the month. Thereafter, 1/12 of prepaid collections for January was transferred or allocated to income for each of the following 11 months, and 1/24 of January collections remained a liability on December 31 and was transferred and recognized as income for January of the following year.

Prepaid dues for each month of the calendar year were treated in the same manner, that is, 1/24 of such collections was transferred and recognized as income in the current month when collections were made, 1/12 of such collections during the following 11 months and 1/24 thereof in the last month when membership expired. The monthly collections of prepaid dues during a calendar year which were recognized and transferred to income during the current year and the portion thereof remaining in the liability account at the end of the year, which was entitled DEFERRED REVENUE MEMBERSHIP DUES, UNEARNED AND DEFERRED INCOME or some similar title, appear in the following tabulation:

	Portion Treated as Income for the Current Year	*Portion Remaining in the Liability Account Dec. 31 and Treated as Income the Following Year*
January	23/24	1/24
February	21/24	3/24
March	19/24	5/24
April	17/24	7/24
May	15/24	9/24
June	13/24	11/24
July	11/24	13/24
August	9/24	15/24
September	7/24	17/24
October	5/24	19/24
November	3/24	21/24
December	1/24	23/24

The allocation of prepaid dues each month facilitated the preparation of monthly statements of income and expenses. Had monthly collections been equal for each month during a year, the amount recognized as income during the current year and the amount remaining as a liability at the end of the year would have been equal under the foregoing apportionments.

19. Under the method of accounting employed by plaintiff, the proportion existing between dues collected from members of its divisions within a calendar year, which dues were recognized as income during such year, and the proportion of such dues regarded as a liability at the end of such year was as follows for the calendar years 1949 through 1954:

	Portion Recognized as Income During the Year Collected	Portion Remaining in the Liability Account Dec. 31 and Treated as Income the Following Year
1949	49.9%	50.1%
1950	50.0%	50.0%
1951	50.2%	49.8%
1952	50.6%	49.4%
1953	50.3%	49.7%
1954	50.0%	50.0%

20. Commencing in 1954, in order to simplify much internal detail, the plaintiff changed its procedure in the monthly accounting for prepaid dues by the assignment of 50 percent to income for the current year and 50 percent as a liability which matured as income for the following year.

Plaintiff also adjusted certain inconsistencies in its prepaid expense account in 1954. Some division managers were paid a straight salary, whereas others were paid a nominal salary plus incentive commissions based upon the number of members within the division. These incentive commissions had been previously charged to the prepaid expense account and prorated over membership periods, whereas such incentive pay was actually a part of the manager's compensation. It was treated as current expense in 1954 and thereafter. Also, guaranteed commissions to new salesmen for a certain limited period had been included with commissions earned on subscriptions obtained, as prepaid expense, and beginning in 1954 such unearned guaranteed payments were charged to current expenses.

The plaintiff continued the apportionment of prepaid dues collected and prepaid expenses for commissions and insurance over the period of membership as it had done previously. The basic method of accounting employed by plaintiff in 1954 was consistent with that employed by plaintiff in 1953 and prior years.

21. The income reported by plaintiff in its tax return for the calendar year 1953 attributable to dues received from members of its divisions was $3,337,813.44, representing $1,562,042.23 of prepaid dues collected in 1952 but not recognized as income until 1953, plus $1,775,771.21 of dues collected in 1953 and recognized as income in that year.

For 1954, dues reported by plaintiff as income for purposes of the Federal income tax totaled $3,794,672.20, representing $1,755,407.46 of advance dues collected in 1953, but not recognized as income until 1954, plus $2,039,264.74 of dues collected in 1954 and recognized as income in that year.

22. The method of accounting employed by plaintiff during the years in issue has been used regularly by plaintiff since 1931 and was used both before and after plaintiff was required to pay Federal income taxes. The method of accounting employed by plaintiff during the years in issue is in accord with generally accepted accounting principles and practices and is customarily and generally employed in the motor club field.

The Internal Revenue Service did not question the method of accounting employed by plaintiff in computing its net income until the calendar year 1954, at which time deficiencies were proposed for the calendar years 1950, 1951 and 1952, but plaintiff was not required to pay those deficiencies by reason of a compromise settlement.

23. Under generally accepted accounting principles a distinction is made between a financing transaction and a revenue or income transaction. Funds received in a revenue or income transaction are reflected in the profit and loss statement of a taxpayer as gross income. This is not true in the case of funds received in a financing transaction. They are reflected in the balance sheet as liabilities.

Financing transactions involve ways and means of raising funds for business operations and may be grouped under three general types: (a) funds obtained from shareholders in exchange for stock; (b) funds obtained from banks or other lenders on notes, bonds or other evidence of indebtedness; and (c) funds obtained by advances from customers or members on open accounts, receipts or certificates of

membership for future delivery of goods or services to be rendered in the future.

Funds representing advances from customers or members of an organization are not income at the time they are received but constitute a liability until such time as goods are delivered or services are rendered or made available in accordance with the advance payment agreement. It is an undisputed principle of accounting that no revenue or income can emerge until goods are delivered or until services are rendered.

Upon the prepayment of annual dues a member of the plaintiff corporation acquired a right to receive certain materials, information and services provided in the membership agreement over a 12-month period. Plaintiff's liability to such member cannot be completely discharged until the expiration of the membership period. Under generally accepted accounting principles, it is realistic and reasonable to recognize and transfer to gross income such prepaid dues ratably over the period of membership.

24. The determination of additional income by the Commissioner of the Internal Revenue Service for the taxable years involved herein was made by including as income the advance payment of dues covering membership benefit periods in the following year and excluding those payments received in the prior year that covered membership benefit periods in the current year. This application of the receipt of funds as income is contrary to generally accepted accounting principles and practices.

By taking into income for the current year the plaintiff's liability for servicing membership periods in the following year, the amount of such receipts would be reflected in the plaintiff's surplus account at the end of the current year. The plaintiff's balance sheet as of December 31, 1953, filed with its tax returns for 1953 and 1954 reflecting the items involved, is compared with the balance sheet which would result from the adjustments by the Commissioner of the Internal Revenue Service in the following table:

	Balance Sheet on December 31, 1953	
	(a) Reported by the Plaintiff	(b) Reflecting the Adjustments by the Commissioner of IRS
ASSETS:		
Cash	$1,941,723.88	$1,941,723.88
Prepaid membership cost	308,482.36	
Prepaid commissions	177,079.51	177,079.51
All other accounts, net	2,834,525.72	2,834,525.72
Total assets	5,351,811.47	4,953,329.11
LIABILITIES:		
Unearned and deferred income	1,756,485.46	
All other liabilities	1,063,462.99	1,063,462.99
Total liabilities	2,819,948.45	1,063,462.99
SURPLUS	2,531,863.02	3,889,866.12

The above statement (b), embodying the adjustments by the Commissioner of the Internal Revenue Service, reflects an overstatement of surplus for 1953 of $1,358,003.10, or approximately 54 percent in excess of the true surplus.

By applying similar adjustments to plaintiff's balance sheet as of December 31, 1954, the surplus would be increased and overstated by $1,634,840.81, or approximately 99 percent, and would omit plaintiff's liability to members for a similar amount.

A balance sheet as of any given date represents an inventory of cash and accounting evaluations of all other asset accounts and liability accounts of an individual or firm on the date designated, and is prepared for the purpose of reflecting the net worth and financial responsibility of such firm or individual.

The evidence establishes that reputable members of the accounting profession would not certify to the accuracy of the income statements and the balance sheets reflecting the adjustments by the Commissioner of the Internal Revenue Service.[1]

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[1] Defendant offered no testimony. Plaintiff's testimony consisted of that of its staff auditors supplemented by outstanding certified public accountants testifying as experts who were, also, either familiar with plaintiff's problem or had some direct association with it and whose qualifications were not challenged. They were: *Dr. Wm. A. Paton*, for 44 years a professor of accounting and economics at the University of Michigan and an author and consultant on accounting. *George E. Baker*, Washington, D.C., resident partner of Ernst and Ernst, Certified Public Accountants. *Herbert F. McAuley*, a general and

25. The defendant contends that the sole issue is whether the Commissioner of Internal Revenue erred in refusing to allow plaintiff to defer a portion of income actually received, without any restriction as to its use, from the year in which it was received to the following year when services might have to be performed under the membership contracts.

The advance payment on a service contract, or any other type of contract, does not constitute income or revenue to the recipient, although the acceptance thereof creates a liability to perform. Under generally accepted accounting principles, the accounting for the funds received in advance must be recorded as a liability of the recipient. The plaintiff did this consistently since 1931. These membership contracts entitled the members to receive membership services over a period of 12 months from the date of subscription and acceptance. The plaintiff's gross income from dues was measured by collections for the period memberships were in effect during the current year. This included pro rata amounts of prepaid dues collected in the prior year covering membership periods that extended into the current year, but excluded prepaid dues collected in the current year for membership periods that extended into the following year. The membership service costs and other operating expenses paid or incurred during the current year were then deducted from such gross income for its determination of net income.

The method of accounting employed by plaintiff was in accordance with accepted accounting principles. The assignment and transfer of funds from the prepaid dues account to revenue or gross income measured over the period of the membership contracts is found to be the most realistic method for properly recording gross income from dues.

26. The restriction of funds represented by prepaid dues was not required or intended by the plaintiff's members. On the contrary, the receipt of prepaid dues from members constituted the principal source of plaintiff's operating funds as heretofore found. Funds from other sources, such as sales of publications, materials and supplies, advertising, etc., were normally received only after the costs and expenses were incurred in producing such revenues.

Managing partner of Ernst and Ernst. *H. Alexander Bell*, partner in Prot. Marwick, Mitchell & Co., largest firm of Certified Public Accountants in the world.

There is no evidence that membership contracts, or certificates issued by plaintiff to its members, provided any restriction in the use of funds received by plaintiff for dues paid in advance. Plaintiff's financial responsibility is not questioned.

27. The plaintiff prepared and submitted tabulations of the aggregate costs incurred by all of its divisions in servicing all members thereof for each month of each year from 1948 through 1954. These tabulations were received as plaintiff's exhibits 2 through 7, inclusive.

Had the plaintiff recognized, assigned and transferred to its gross income account its monthly receipts of dues collected in advance in the proportion to its cost of servicing all of its members each month, instead of ratably over the membership period of 12 months, the proportion of advance dues which would have been recognized and assigned to gross income during the years in issue herein would have been substantially the same as the gross income from dues as determined and reported by the plaintiff under the method of accounting actually employed.

28. The proportions of prepaid dues transferred and assigned to gross income by the plaintiff on a pro rata monthly time basis are compared with the proportion of assignments under the average monthly cost bases for servicing memberships in the following table:

	Plaintiff's Pro Rata Method as Reported	Average Monthly Costs for Current Year	Average Monthly Costs Over Prior 1-Year Period
1953			
Apportioned to Gross Income during current year	50.3%	49.8%	50.4%
Deferred to the Following Year (reported as a liability at the end of the current year)	49.7%	50.2%	49.6%
1954			
Apportioned to Gross Income during the current year	50.0%	48.8%	51.0%
Deferred to the following year (reported as a liability at the end of the current year)	50.0%	51.2%	49.0%

29. The recognition, assignment and transfer of dues collected in advance to gross income on the basis of actual costs of servicing members is feasible under the accrual method

of accounting, particularly in testing the results of prorating such collections on a time basis. It is not as practicable as the assignment of prepaid dues on a pro rata monthly basis because the current costs incurred must first be determined. The employment of a prior year's monthly costs or a composite of monthly costs for five prior years might not be as accurate as the method actually employed by plaintiff because of a constant increase in membership reflected over the years or by abnormal costs of servicing members during one or more of such prior years.

When members paid their annual membership dues they became entitled to membership services over a period of 12 months, notwithstanding any variations in costs to the plaintiff in furnishing the services that might be required. When plaintiff accepted such dues it became obligated to perform the services to which members were entitled and might require over the membership period without regard to any variations or fluctuations in costs in furnishing such services from month to month over the membership period.

On the evidence presented, the recognition and assignment of prepaid dues ratably over the period of membership is found to be the most realistic and practical method of accounting for gross income from membership dues.

30. The plaintiff's membership for all divisions reflects a constant increase from month to month during 1953 and 1954. The minimum number of memberships in effect in 1953 was 229,435 in January and the maximum was 246,856 in December of that year. The minimum number of memberships in effect in 1954 was 249,805 in January and the maximum was 295,889 in December of that year. The average cost to plaintiff of servicing a member during the calendar year 1953 was $14.50 and the average cost for 1954 was $14.72.

31. The plaintiff's liability for servicing members whose membership continued beyond the current year when dues were paid was not a "contingent" liability. It was a true liability and the costs were substantially in proportion to membership from year to year with reasonable constancy from month to month. The plaintiff's actual costs of serv-

ing all members from 1948 to 1954 are set out in the following tabulation:

1948	$1,587,794.87
1949	1,698,144.27
1950	2,012,406.23
1951	2,614,386.96
1952	3,109,098.21
1953	3,377,389.91
1954	3,991,068.00

32. The actual average monthly cost per membership in effect during 1953 and 1954 and the percentage of the total annual cost per member is reported in the following tabulation, with the percentage of the total monthly costs to the total costs for the preceding five-year period:

Month	1953			1954		
	Average monthly cost per member		Percent of monthly costs to total over prior 5-year period	Average monthly cost per member		Percent of monthly costs to total over prior 5-year period
	Amount	Percent of cost for year		Amount	Percent of cost for year	
January	$1 12	7 71	7 48	$1 12	7 62	7 46
February	1 10	7 57	7 47	1 27	8 62	7 34
March	1 24	8 52	8 54	1 35	9 27	8 44
April	1 32	9 15	8 84	1 24	8 41	8 82
May	1 28	8 84	8 97	1 35	9 18	8 83
June	1 32	9 12	9 04	1 41	9 56	9 07
July	1 35	9 29	8 90	1 34	9 12	8 93
August	1 23	8 52	8 58	1 24	8 41	8 67
September	1 19	8 25	8 15	1 20	8 16	8 26
October	1 19	8 19	8 20	1 17	7 95	8 42
November	1 06	7 29	7 56	1 10	7 39	7 65
December	1 10	7 59	8 29	91	6 21	8 11
Total	14 80	100 00	100 00	14 72	100 00	100 00

The foregoing tabulation reflects the actual average cost to plaintiff in each month of the years involved for each member whose membership continued in effect. The difference between the costs incurred for servicing memberships that continued from the prior year and the membership fees collected in the prior year, but remaining as a liability of the plaintiff at the end of the year and transferred to gross income in the current year, would represent the net income in the current year applicable to such memberships.

33. The plaintiff's liability to members for that portion of their memberships which extended beyond the current year

in which plaintiff collected the dues in advance is not gross income from membership dues because it was paid and received for a later year. Neither can it be net income in the year when the dues were received because the cost of servicing such memberships could not be performed until the following year when such net income would be realized.

The method of accounting employed by the plaintiff during the calendar years 1953 and 1954 and prior years in keeping its books and records clearly reflected its net income for such years. The plaintiff's income tax returns for 1953 and 1954 were prepared in accordance with the method of accounting employed in keeping its books and records and clearly reflected the net income for these years. This conclusion and the findings set forth above are supported by the overwhelming weight of the documentary evidence and expert testimony.

Respectfully submitted.

MARION T. BENNETT, *Commissioner.*

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